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August 15, 2011

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Dear Ms. Rupp:

On behalf of SACU (San Antonio Federal Credit Union), I am writing in response to the Advanced Notice of Proposed Rulemaking - Derivatives. I thank you for this opportunity.

Derivative ANPR Response

SACU

A. Existing Pilot Programs

Question 1: Should existing Pilot Programs for FCUs to engage in derivatives for IRR management be permitted to continue?

Answer: We feel credit unions should be able to use derivatives to hedge balance sheet risk. Access to any type of program, whether third party or independent, should be reserved for credit unions that are able to demonstrate an appropriate level of knowledge and expertise to engage in the safe use of derivatives. Existing Pilot Programs that have operated safely and have proven valuable should be allowed to continue and new parties should be allowed to petition for Pilot Program status until a longer term solution is in place. The existing third party model should be the basis for a permanent, managed process (third party or independent) that will bring derivatives as an interest rate risk management tool to credit unions.

Question 2: Should such Pilot Programs for FCUs be permitted to continue by "grandfathering" the previous approvals into Part 703?

Answer: Yes. Credit unions already approved into existing Pilot Programs have spent a significant amount of time and effort in meeting the guidelines and operating standards set forth in these programs. Additionally, they should not be penalized for taking a proactive stance in terms of managing interest rate risk. Forcing these credit unions to re-complete this effort would be a waste of their time. Their participation in an existing or new third party provider system should be grandfathered.

Question 3: If FCUs seek an end-user exception from mandatory clearing as contemplated by the CFTC's proposed rule, they would need to provide items of information to a registered swap data repository. In view of this requirement, should NCUA permit FCUs to seek and end-user exception?

Answer: While somewhat difficult to answer without a finalization of the proposed guidelines, we believe that credit unions should have the option to seek an end user exception and should therefore be required to submit all of the requisite documentation in accordance with the guidelines.

B. <u>Third Party Derivative Authorization</u>

Question 1: These third party standards would require replacement of credit quality references by functional equivalents. With this change, are the third party operating standards required in NCUA's Pilot Program generally appropriate to govern the use of derivatives by an FCU approved to engage in these activities through a third party?

Answer: As a result of changes in the financial industry, specifically with respect to credit quality, some adjustments should be made to the exiting third party standards:

a) Financial Condition – the proposed net worth ratio of 7 percent and stable positive earnings for preceding 12 months requirement may prohibit credit unions from hedging when they most need it. Banks and other financial entities are not prohibited from hedging based on earnings, capital levels or balance sheet make up – nor should credit unions.

The 7% net worth ratio should be reduced to 5% and NCUA approved exceptions should be allowed on a case by case basis for credit unions that fall below this level. Additionally, the guideline requiring 12 months of positive stable earnings should be removed; as it makes risk management decisions a function of financial strength. It does not make sense to prohibit a credit union from using a risk management tool due to one quarter of negative earnings. Effective, proven risk management tools should not be limited based on financial condition as long as both parties to the contract have the ability to fulfill their obligations under the respective contract.

b) Counterparty Credit Quality – we believe that the credit quality requirement of third party providers should be changed to language that requires either; a public rating of

AA- or better, and/or a bilateral collateral agreement as well as a maintenance margin designed to eliminate credit exposure. We would suggest (1) FHLB counterparties should be allowed as long as their ratings are AA- or better without a bilateral collateral agreement in place. (2) All bank counterparties (regardless of rating) must have a bilateral collateral agreement in place that 100% collateralizes market exposure when their public rating falls below AA-. (3) Non-rated entities should be required to post collateral and maintenance margins that protect credit unions from the outset of the trades. Historically, FHLB's have not agreed to the use of bilateral agreements with credit unions and while it is possible that many will not offer hedging services in the future, the rules should be designed to easily allow their use. Banks should be required to post collateral to mitigate exposure. Additionally, maintenance margins, which are designed to protect against rapid and or large short term adverse market value changes, should be mandatory if the bank were to fall below an A rating. It is unlikely that any existing or future corporate credit union entity or credit union CUSO would be able to obtain a public credit rating. These parties should be required to post collateral and maintenance margins at all times to eliminate any/all counterparty credit exposure.

c) Hedge Transactions – we believe the existing guidelines surrounding hedge transactions to be sufficient.

d) Modeling – we believe third party provider guidelines relating to modeling are sufficient and continued enforcement of existing guidelines is all that is necessary.

e) Internal Controls – we believe existing third party provider guidelines relating to modeling are sufficient and continued enforcement of existing guidelines is all that is necessary.

f) Legal Issues – we believe existing third party provider guidelines relating to legality are sufficient and continued enforcement of existing guidelines is all that is necessary.

g) Transaction Termination – we suggest changing the guidelines to read that in the event the hedge fails the limits of effectiveness testing the credit union will seek to restore the effectiveness relationship through the de-designation/re-designation process within a timely basis or terminate the trade when it is practical to do so. Also, terminations should not be required, based on ratings downgrades, as long as the counterparty complies with the proposed bilateral and maintenance margin agreement guidelines.

Question 2: If FCUs lacking prior experience with derivatives were required to spend a period of time within a third party Pilot Program, what period of time and/or number of transactions is reasonable to a safe and sound understanding of derivates?

Answer: The ability to attain a safe and sound level of derivative understanding is a function of many factors and should not necessarily be governed by arbitrary time and volume guidelines. Credit unions using a third party Pilot Program to gain expertise should

have to demonstrate the ability to comply with all regulations and guidelines independent of such a provider prior to seeking independent status. Third party Pilot Programs were specifically designed to provide an expert partner to credit unions in order to provide the safe and effective use of derivatives as a risk management tool. Guidelines to judge expertise and understanding should be a function of expertise and understanding, not numeric targets.

C. Independent Derivatives Authorization

Question 1: Should the NCUA Board consider allowing credit unions to engage in derivatives activity independently:

Answer: Yes. Credit unions possessing the expertise and knowledge to engage in independent activity should be allowed to do so. This should be limited to credit unions that have demonstrated the ability and expertise through the use of an existing third party provider over time and/or by demonstrating the knowledge and expertise independent of an outside provider. Not all third party users may qualify for independent activity, but should have the change to demonstrate the ability to operate independently.

Question 2: What are the attendant criteria, such as asset size, capital adequacy, balance sheet composition, or risk exposure with or without derivatives that NCUA should take into consideration in evaluating a credit union's request for approval to engage in derivatives independently?

Answer: Credit union participation should be a function of knowledge, understanding and expertise rather than be based upon a numerical attribute of the balance sheet. Factors such as size, composition and risk exposure should not be the determining factor of those allowed to have independent authority. Credit unions seeking independent authority should be required to demonstrate not only the expertise required under the third party provider model, but also additional skills such as trade execution and contract pricing using current market data to ensure cost effective execution.

Question 3: Are there specific actions a FCU should expect to take in preparation for applying to engage in derivatives activities independently?

Answer: Yes. Credit unions should continue to satisfy all existing third party provider rules and guidelines in order to operate independently. This includes valuing and risk shocking existing trades in their ALM model, demonstrating how and why the hedge benefits the balance sheet, calculating mark to market values for valuation and recording purposes, calculating payments to be made and received under any executed transaction, and to understand and comply with appropriate accounting rules related to any transaction. Also, credit unions seeking independent authorization should be required to demonstrate the ability to price/value contemplated trades independently using live market data in order to

prevent egregious dealer mark up. An additional guideline should be the demonstrated ability to easily calculate mark to market values on a daily basis for collateral posting purposes. Inability to do so may put the credit union in a position where it relies on a professional counterparty to determine when more collateral is needed or when excess collateral should be returned. Professional counterparties have historically been quick to seek additional collateral but unresponsive in returning excess (bilateral collateral agreements don't force dealers to send collateral when applicable, they require them to do so only when prompted).

D. <u>Approval Standards for Derivative Activities Through an Approved Third Party</u>

Question 1: Should NCUA require an FCU to state a balance sheet management plan to hedge IRR based on risk management objectives as a condition for approval?

Answer: No. Existing guidelines for third party providers require credit unions to examine their current risk situation and the effects of any contemplated hedge prior to execution. Requiring credit unions to submit balance sheet management plans as condition of approval adds an unnecessary step that is already included in current guidelines.

Question 2: Is it useful for an FCU to rely on the expertise of a third party to assess the effectiveness of derivatives to hedge IRR on an ongoing and dynamic basis or should the FCU be required to demonstrate it has this expertise internally as a condition for approval?

Answer: Yes. The purpose of third party programs was to assist credit unions in gaining access to the knowledge and expertise that would enable them to safely use derivatives as a hedging tool. The goal of the third party provider system is to allow the participating credit union to lever resources as it gains the experience and knowledge needed to safely and effectively use derivatives.

Question 3: Is it useful for an FCU to rely on the expertise of a third party to assess the credit quality of derivative counterparties?

Answer: In a system where the third party is the counterparty, and uniform bilateral collateral agreements (and maintenance margins) are in place in order to eliminate credit exposure, the question is irrelevant. If credit unions were to rely on the third party without these agreements, then the answer is no, as there could be a conflict of interest. In a system where the third party provider only brokers the transaction, we would argue that those same uniform bilateral collateral and maintenance margin agreements would have to be in place, or the provider would have to be held to an extremely high standard in its' fiduciary role as an agent of the credit union. Providing the credit union with a counterparty that the third party feels is sufficient, does not meet the proper standard of protecting the credit union against credit exposure. We feel the proper way to remove the credit component from the equation is by leveling the playing field by requiring uniform bilateral agreements.

E. Approval to Engage Independently

Question 1: Should approval of an FCU to engage in derivatives activities be in the form of additional authorization similar to the expanded authority available under Appendix B to Part 704 – Expanded Authorities and Requirements?

Answer: Yes. Credit unions wishing to engage independently in derivative activities should have the option to do so and should, at a minimum, be held to a similar standard as the third party.

Question 2: Should an FCU demonstrate enhanced credit functionality in terms of the experience of the FCU's personnel, credit analysis and reporting infrastructure in order to evaluate the creditworthiness of derivatives counterparties?

Answer: Maybe. If credit union and providers adopt risk mitigation models that fully collateralize exposure with additional margins to guard against large adverse changes in value, then there would be no need for enhanced credit functionality. In the instance where a swap provider is only willing to post collateral on a sliding scale to an independent (i.e. a counterparty would be required to post a specific amount of collateral dependent on a specific rating), enhanced functionalities may be required to track and quantify potential risk of loss to single or multiple counterparties. We believe this applies to independent and third party provider systems. A system that mandates a fully collateralized exposure with additional maintenance margins is the best way to guard against loss.

Question 3: Should an FCU demonstrate enhanced hedging expertise based on the experience of FCU's personnel or on additional derivatives management infrastructure?

Answer: Yes. A credit union wishing to engage in derivative activity independently should have the additional expertise and infrastructure not required in a third party system. In a third party model, trade execution is handled by the third party. Direct execution at the credit union level may require more technical expertise than currently in play in a third party setup. A credit union would also have to demonstrate access to a "live" pricing system or resource (like Bloomberg) that would enable it to check that prices are accurate and fair. A credit union would also have to independently be able to calculate the risk attributes and balance sheet effects of any contemplated or executed positions.

Question 4: Is one year a sufficient amount of time for an FCU to fully prepare a self-assessment and application for approval to independently engage in derivatives to offset IRR?

Answer: Time should not be the overriding variable by which a credit union's ability should be measured. Some credit unions that have participated in existing third party programs may currently possess the necessary skill set to operate independently, while others may

not. This is not a function of time, but of the skill level and experience of senior management and staff as well as internal system capabilities.

Question 5: Are there any additional aspects of the FCU besides items (i) – (v) above which the NCUA should consider in its approval for the FCU to engage in derivatives activity independently?

Answer: The Pilot Program which has been in place has afforded many credit unions the means to safely and appropriately add hedging instruments to their arsenal of risk mitigation tools. Expertise which resided in the Corporate Credit Unions (specifically WesCorp) allowed natural person credit unions to gain the knowledge and expertise needed to gain approval into the program and to eventually begin using these tools. Credit unions that have used these strategies via the pilot program may be in a position where they wish to seek approval to operate independently. Being one of these institutions, we definitely see the benefit of having options in terms of directly facing the street. However, we also have learned first hand (after having our positions transferred to Wells Fargo) that we do not have the size or scale to warrant any level of service. Additionally, many credit unions will not have the means to add the appropriate level of staff needed manage counterparty risk, value collateral, etc. An appropriate compromise would be to allow credit unions to seek independent approval where appropriate as well as to rebuild the program in one the new corporate credit unions or CUSOs – this would be helpful even if the services provided were to replace those currently being offered through ALM First.

Thank you for your consideration.

Sincerely,

Mark Dwyer

Mark Dwyer
SACU, Chief Financial Officer